RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

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Oct. 24, DJIA 943.60; PTI 1342; A-D Ratio –17.98
Oct. 31, DJIA 924.49; PTI 1333; A-D Ratio –17.06

THE PICTURE: This Letter, unfortunately, is being written just before the Presidential election, and I (lacking a reliable crystal ball) don't know which candidate is going to win. But the truth is that even if I did know who was fated to win, I wouldn't know how the market was going to react to the move. So the best thing to do is keep our eye on the market rather than the news and rumors of the day.

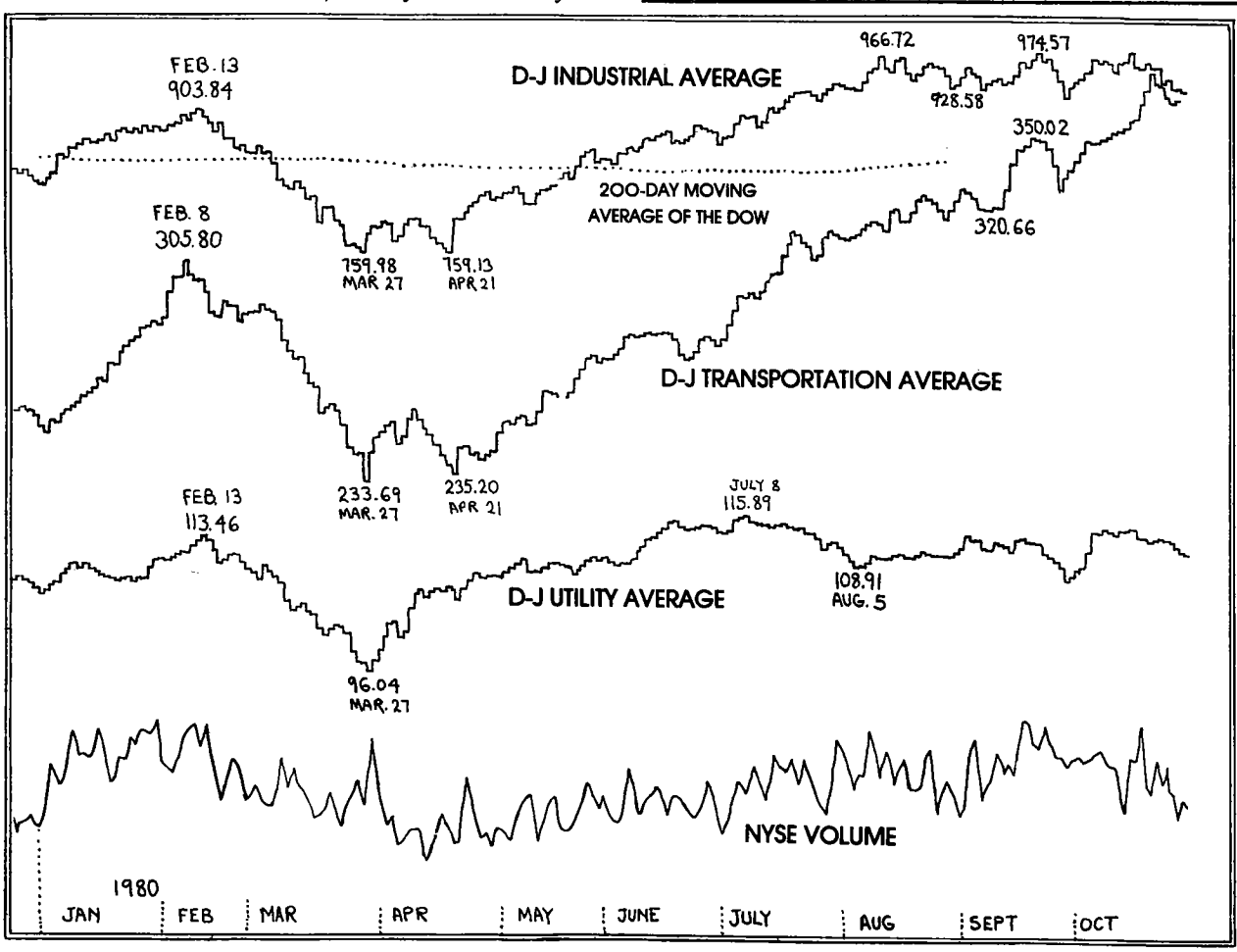
One of the great football coaches of our times, Tom Landry of the Dallas Cowboys, said (in a recent interview), *"If you're going to do something constructive from a coaching standpoint, you must be completely engrossed in what's going on, not in the emotions of the game."*

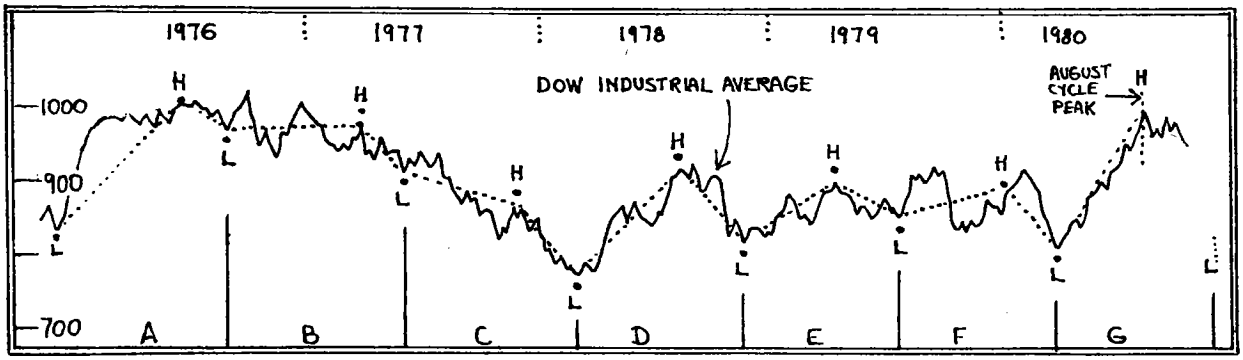
What's true in the very tough game of professional football is doubly true in the game of investing. There's no more costly procedure in investing than letting your emotions dictate your investment policy. Whereas fear, anger, enthusiasm, even stubbornness can often take you very far in the game of life, they can sink you like a stone in the world of investing. In the markets you've got to lead with your head, not your heart—and you can't get married to any single investment. Fall in love with stocks, fall in love with gold, fall in love with IBM or Control Data or wheat or cattle, and you're on the way to losses. Love is the greatest force in the world, and the ability to love makes life in the real world worthwhile. But, when your stock or your

FRONT PAGE COMMENT: I've talked about debt and illiquidity probably more than any news letter writer around. But I've never said this before, and I'm going to say it now. I BELIEVE THE PICNIC FOR BORROWERS IS OVER! This nation is now illiquid. It's corporations are illiquid, many are borrowing to pay dividends. GM, our largest manufacturer, is selling a division to raise money. Chrysler is broke, Ford is getting there. The US Federal budget *deficit* for the year ending Sept. 30, was $58.9 billion, second biggest in history and twice last year's. The prime bank rate is up to 14.5%, and this before the election. The Treasury is borrowing its head off, and has just announced that its fourth quarter borrowing will be $25 billion with $18 to $22 billion needed for the first quarter.

The picnic for borrowers is over! Long-term money is increasingly hard to find, and the short-term market is crowded. The bill rate (12.5%) is about at the inflation rate, and if you want to borrow at the banks you are going to pay OVER THE INFLATION RATE.

Turn to the chart of the bill yield on page 2. As you can see, the 91-day bill yields have been walking up a rising trendline ever since June. This trendline has been tested three times; it has a powerful look. The drop from the record yield of just over 16% in April to the June low of just over 6% was 10 percentage



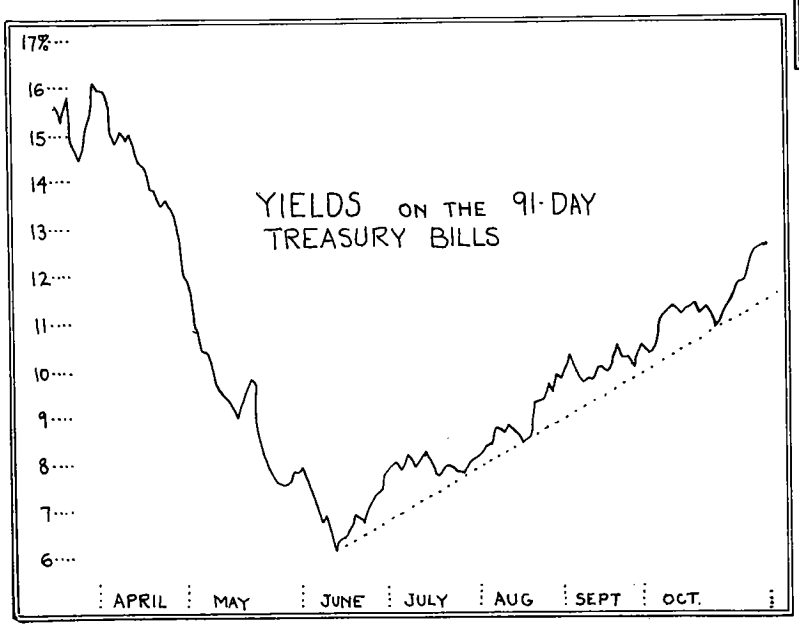


bond or commodity turns down, kick it out of the way as you would a dead fly. That's the way the game is played on Wall Street, and that's why it's such a tough, heartless, soulless game!

So saying, let's turn to the market action of the past few weeks. We know that the 233-day market cycle turned down on August 15 and that it is due to bottom around November 10. We also know that the market can fight against the cycle for weeks, then make up for lost time as it surges in the underlying cyclical direction.

In the current G cycle (see page 2 chart) the Dow hit an August 15 cycle high of 966.72. But instead of turning down with the cycle, the Dow pushed to a further high of 974.57 on September 22. Nevertheless, the bearish segment of the 233-day cycle now seems to have taken hold (as I have suggested it would), and in the space of a few weeks we have seen the Dow flirt with the 900 area.

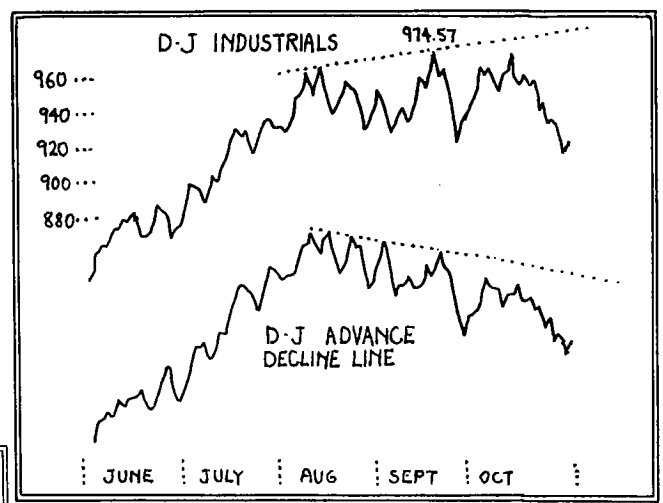
This latest spate of market weakness was preceded by many strange and exotic happenings. For instance, on the week ending October 24 option trading (for the first time in history) involved more stock than the entire volume of trading for the week on the NYSE! During the same week, Amex and OTC trading outpaced total trading on the NYSE (this too, for the first time in history). The implications of these two events are clear–Americans are not investing any more, they are trading, speculating, gambling. Volatility, inflation, erratic price action and froth have ended the concept of long-term investing. It's "double or nothing" on the exchanges in 1980.



points. The bills have already regained better than half of that. The bill yields are nearing 13% now, and my guess is that they may test the highs. If that happens, it will be like a vice on the throat of the economy.

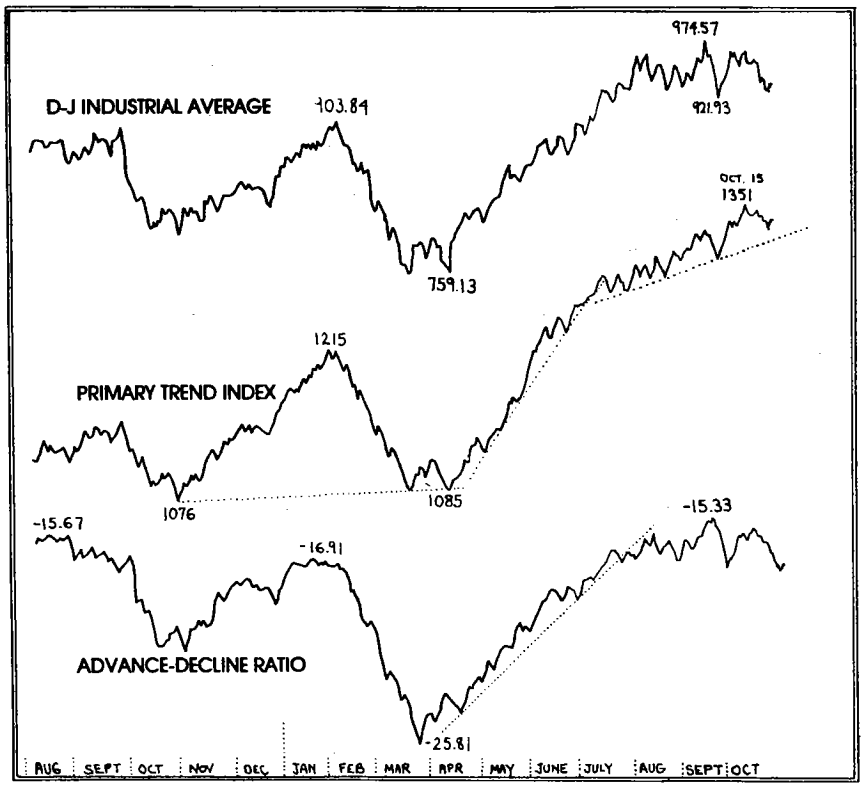
Yes, the picnic for borrowers is over, and I don't care who's elected President. This isn't a political phenomenon, its an economic one. The 1980's are liable to see a liquidity squeeze and a rush for the one commodity that nobody has–cash (and I'm not talking about assets tied up by massive liabilities, I mean cash).

Also preceding the latest market weakness was the divergence in the Dow and its own A-D line. I discussed that divergence in the last two Letters, and I include an updated chart of the Dow and its A-D line below.



On top of the Dow-breadth divergence, a dramatic period of divergence between the Dow and the Transports occurred. In the period of September 22 to October 22 the Industrials lost 19 points while Transports spurted 31 points to a record high. This action can be clearly seen on the page 1 chart of the Averages.

So much for the obvious divergences between the Averages and between the Dow and its own A-D line. Now turn to the chart of the Dow, the Primary Trend Index (PTI) and the A-D ratio. Let's focus on the PTI first. For the benefit of new subscribers, the PTI is my own proprietary index–it's actually an amalgam of eight critical averages and indices. I use the PTI to track the underlying trend of the market. I developed the PTI in 1970-71 because I had learned (to my frustration) that any index or average can go haywire and give false signals at any given time. But the PTI will not be fooled. As long as the PTI is trending up, I know



that the technical "weight of evidence" is building in favor of higher prices. The reverse is true whenever the PTI turns down and holds below a declining trendline.

To review the picture, the steep rising trendline in the PTI held in force from April to July. During July the PTI formed a shallower rising trendline, and this latest trendline has held in force to the present. If the PTI breaks below this latest trendline, we could have the beginning of a defined downtrend in the PTI. That would be the first time this has occurred since the advance started in April.

Will the PTI slide into a sustained decline? I have long ago given up the idea of predicting the PTI. We do know that the Dow has confirmed the A-D ratio in the downward direction. We do know that the Industrials and Transports have been declining *together* over the past two weeks. I attach a good deal of importance to the following: the D-J Transportation Average has been walking up a perfect rising trendline ever since April 21 (you can draw this trendline on the page 1 chart). A Transport closing of 350 or below will break that 6-month trendline. If this occurs, I would say that we were witnessing significant weakness.

Subscribers may remember that I have often said, "Watch the strongest indicator in the market; when it finally turns down the indications are that the trend is reversing." The two strongest indicators during this rise are the PTI and the Transports. Those are the ones I am watching now.

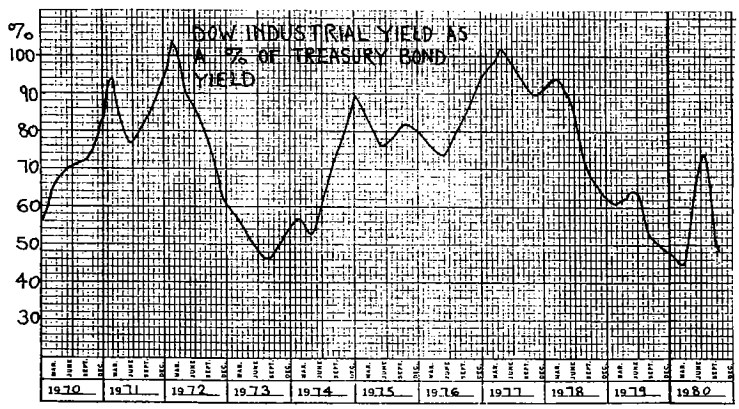
Conclusion: I'm continuing to *keep my powder dry*. The bearish segment of the 233-day cycle ends around November 10 (give or take a week). I want to see how the market does in the period between now and mid-November. I might as well add that I am not impressed by all the guesses about "What the market will do if Carter or Reagan gets elected." Politicians don't make markets, more often markets make (or break) politicians."

MORE ON YIELDS: In the last Letter I stated that I thought yields would provide the big financial story for 1981 (and maybe for the final quarter of 1980). Since the whole money area of finance is one of the least understood of any area, I want to go into the yield picture a bit further in this report.

I include here a monthly chart of the yield on the D–J Industrial Average as a percentage of the US Treasury bond yields (statistics for this chart courtesy of Juncture Recognition, Box 1209, Pompano Beach, FL 33061). Note the major swings in the percentages. In early 1972 and again in mid-1977 Dow yields were over 100% of T-bond yields. That was a healthy ratio, meaning that an investment in the 30 common stocks in the Dow would provide as big a yield as an investment in Treasury bonds.

In mid-1973 the ratio dropped below 50%, which meant that Dow yields were less than half as large as the Treasury yield. At that ratio, the Dow stocks were richly valued.

In early 1980 the percentage again dropped below 50%, but here the low ratio was brought on by an almost complete collapse in the bond market with accompanying very high interest rates. When interest rates broke, the stock market rallied strongly into the present area. Now, interest rates are very high and the ratio has again dropped below 50%.



So we can see that the current high rates on bonds has the effect of lowering stock valuations. In other words, when Treasury bonds yield twice what good stocks yield, the pressure is on stocks. As I see it, the money market will loom particularly important in 1981. If rates are brought down, the stock market will have room to rally. But if rates stay high or continue higher, a ceiling will be placed on stocks.

Because of the flagrant pressure placed on the Fed just prior to the election (via Carter and Miller), it is my opinion that the "real interest rates" may not surface until the election is over. Traditionally, the President, the Congress and the Fed must get down to serious business following an election. This is how I see it: The 6-week rate of change for M1-B (6 weeks ending October 8) was 18%. The Fed is going to have to cut that rate in half or less–or risk hyperinflation. Either way, we could get a "blow-off" in interest rates.

A few observations are worth making at this time. The bond market over the past month has been in shambles. Issue after issue has been pulled off the market, while those new issues

which have been sold, have not gone well. Many new bond issues have been only partly sold by the underwriters so that these bonds have had to be thrown on the market for whatever they would bring. When bonds fail to sell out as they have, it means that the market has to be sweetened, and the sugar is still-higher interest rates. Thus each new coupon has been higher than the last, but the bond market remains panic stricken regardless of the level of yields.

The Federal Government will be a mighty contender in the money market during coming months, and the spector of "crowding out" is looming. The Federal debt is pushing the $1 trillion level. At merely 10% this means that the Fed will need near $100 billion to service the fiscal 1981 debt (vs. $70 billion this year). Add to this the huge sums that will be required for the US defense build-up and you get some idea of what the bond market is looking at (and mind you, this has nothing to do with which political party is in power).

At this point I want to repeat what I said on page 1 on the last Letter. I believe that INTEREST RATES are going to be the big story of 1981 and beyond. No amount of manipulation by the Fed, no presidential scolding, can hide the pressure being generated by the rocketing debt and the need to service that debt.

The operative concept (which every investor should memorize) is this: the debt of the US and the cost of servicing that debt are both rising on an exponential basis REGARDLESS of economic conditions (in fact, the debt rises even faster during a recession). BUT the earnings and cash flow of the US and its population and its corporations ebb and flow with the economic cycles. Thus, the time is approaching when the US will *not be able to service its debts.* The barometer of this coming crisis is the level of interest rates. The nearer the crisis, the higher the interest rate level and the more violent the interest rate action.

Here's another concept that I want all subscribers to think about. Rising interest rates are a function of rising inflation–but rising interest rates (paradoxically) will ultimately be deflationary. Why will rising interest rates ultimately be deflationary? Because at a certain point, rising interest rates will cut off all risk capital and all alternative investments. Look at it this way, as an investor you may believe in inflation forever, but at 10% yield money doubles in 10 years, at 12% money doubles in 6 years and at 14% money doubles in 5 years. As the return on safe money (short-term money) rises, it approaches the point of being irresistable to investors. This point may be 14%, 15%, or 18%, I don't know, but rising rates will at some level absorb all funds and successfully compete against all investments. At this point, the economy will topple over and inflation will hit a brick wall (as money pours out of "things" and into high-yielding instruments).

As I see it, the US economy is now walking the line between inflation and deflation; it is walking the line between rising credit and debt - - and illiquidity. That line is getting thin, mighty thin.

THOUGHTS: To my way of thinking, nothing, no line of work or endeavor, makes sense unless you enjoy it. In our society, money is the standard medium of compensation. If you're good, if you're successful, then the pay-off is "big bucks." And for many that suffices. Which leads to the power syndrome. Many an executive gets ulcers on the job, others have to swallow their self-esteem or submerge their personalities in order to remain on high-paying jobs. But the reward is big money, and because the money is such a social plus, these people go on and on – wasting their lives for monetary gain. I know of no better way of short-changing yourself.

I'm over 55 now, and that gives me the right to philosophize a bit (the more so since I've spent almost half that time in the investment advisory business). And this is what I say: If you don't enjoy your job or your business, if you hate going to work, then you're doing the wrong thing. My advice is to get out and to find something else. Men and women are meant to do some kind of work (or at least to follow some kind of interest), and if you're spending one-third or one-half of your waking hours on a job you don't like–get out. You can't do any worse, and I don't care how much you're making.

I put great store in faces, and I'm pretty good at reading them. I often look at those executive faces in *Forbes* or *Fortune*, and my reaction to at least half of them is ... "Forget it!" They either look angry or exhausted or tragic, and that tells me that it isn't happiness or wisdom or self-knowledge they're heading for.

Now here's another concept that's hard to swallow, but here it is. If you find that you're consistently losing money in the markets (I don't care if you're speculating, trading or investing), stop what you're doing. Either you are incompetent in what you're trying to do, or you haven't learned your subject, or you are trying to do something that you simply should not be doing. In which case, I'd suggest that you put your money in T–bills (and I don't care what the inflation rate is) than to lose consistently in the stock market or any other market.

Here's another concept that you may have to learn the hard way. You cannot depend on someone else to make money for you. There's no such thing as a sure winner. If there is a sure winner out there, then the chances are that he doesn't need you (or if he is willing to take you on, he's going to charge you so much that you might as well forget it. John Train writes a terrific column on this subject in the last issue of *Forbes*). The corollary to this is you must learn about investing yourself. And it's far better to learn something well in a simple area than to fumble and lose money in a difficult area (for instance, you're better off collecting money in T-bills than you are losing it in options).

Here's a very important concept. Keep greed and envy out of your thinking. I don't know how many billions of dollars have been lost by subject A plunging into the market or buying this or that because his good friend subject B made a killing in the stock market last week ("And if B can do it, damn, I can too!"). Confine your investment operations to what you know, what you can handle, what you're psych can live with. If you do otherwise, if you confuse yourself with somebody else's big money maker, you're looking for trouble. The other guy may be a money machine and you may be a great lover. Don't confuse talents and don't confuse your needs and goals with someone else's.

I've written about this before, but I want to repeat it. God gives you what you NEED, not what you want. That's based on the thesis (which I firmly believe) that we're all here for the purpose of moving forward, moving towards perfection. If you spend all your waking moments trying to make money, even if you do make a fortune you may be an utter failure. Why? Because you've spent all your time doing what's easy for you. On the other hand, improving your soul, moving forward and upward spiritually, may be very difficult for you (as it is for most people).

NOTES & QUOTES: You hear ten pieces of nonsense about money for every one that makes sense. This piece is from the Nov. 10 *Forbes* magazine, and I would like my subscribers to study these words.

No letup for borrowers

MOST COMMENTATORS HAVE MISSED the real significance of the current runup in interest rates. The Fed is not just following a cyclical anti-inflation policy. Interest rates have finally topped the inflation rate. Fed Chairman Paul Volcker is determined to keep them there. No longer will the nation's savers subsidize the nation's borrowers and thus, unwittingly, feed inflationary expectations.

Interest rates will not go down until the inflation rate goes down. Even then, interest rates will remain above the inflation rate for a long time. So, don't be fooled by the September rebound in housing or by the third-quarter pickup of 1% in the Gross National Product. The Federal Reserve System has no alternative to heavy-handed use of its only weapon—tight credit, which brings high interest rates. So, housing, which needs huge amounts of reasonably priced capital, gets it in the neck and so do autos, to a lesser degree. You can't have recovery with key industries in the soup.

IN MAY AND JUNE mortgage rates fell to 12%; now they're up to 14.5% and more. Assuming a 20% down payment and a 30-year mortgage, the monthly payments on a modest ($76,000) dwelling were $617 in August; in September, $735. That extra $118 is going to knock a lot of people out of the housing market. Adding taxes, utilities and maintenance, that simple house will now cost $1,000 a month or more to carry—at least $12,000 a year. The median American family earned only $20,000 last year—before taxes.

Meanwhile, the pattern of savings and mortgage lending that has dominated our culture is revolutionized. The small saver is no longer relegated to 5¼% savings accounts and borrowers must pay their way.

* *

Many analysts, including this writer, believe that the "coming area" for investment is going to be the Pacific Basin. The hub of the Far East is Japan, but Australia (now booming), Singapore, Malaysia and Hong Kong are all areas of white hot economic activity. This year Japan's total market capitalization grew to $311 billion, close to Western Europe's $447 billion. In September, foreign purchases of Japanese stocks hit a record $1 billion as US and Arab investors vied for a stake on the Tokyo exchange. The power of Japan can be seen in the rise of the yen, which has been in a major rise (against the dollar) since its low of last April—and this despite the fact that Japan is totally dependent on outside sources for ALL of its oil.

Consider this: The US population is twice that of Japan's. Yet Japanese steel and auto output now equals ours. Japanese investment in new plant and equipment now equals ours. The US rate of savings is now 4%, the Japanese rate is 20%. At current rates, by the end of the 1980's Japan will have a larger industrial economy than the US.

* *

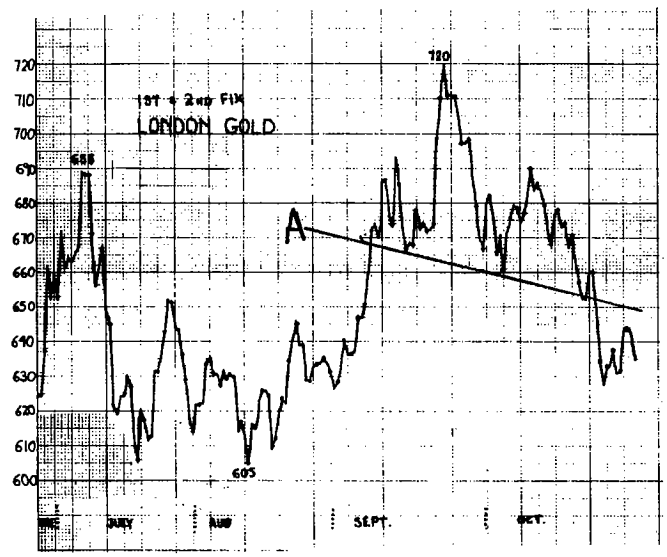
Do you read books and forget them? Do you fancy yourself a hard-core survivor? Brace yourself, you're in for an awakening! I just finished Jack Eisner's *The Survivor* (Morrow). This has to go down as one of the great survival stories of the ages. I recommend it strongly.

* *

Steve Leuthold (he publishes the excellent institutional report, *Perceptions*) writes that he recently had lunch with Peter Bushre, Treasurer of the State of Alaska. Bushre mentioned that he had "Just purchased a ton of gold at an average price of $651" for the State's Public Employees Pension Plan. Very interested, Steve asked, "How much did you buy?" Bushre answered, "A ton." Steve writes, "I was so taken aback that I could not inquire if it was a short ton or a long ton!"

GOLD: With Canada grabbing for the oil companies, can gold be far behind? At any rate, I find it ironic that investors can now worry more about Canadian gold shares than South African gold shares. Almost all governments hate free enterprise (domestic or foreign). Free enterprise is, of course, non-government, and in the end most governments "want it all." I have always said that governments will do ANYTHING they have to–to perpetuate themselves. When governments have financial problems, they grab for where the real wealth is–private enterprise. Happy landing, Canada.

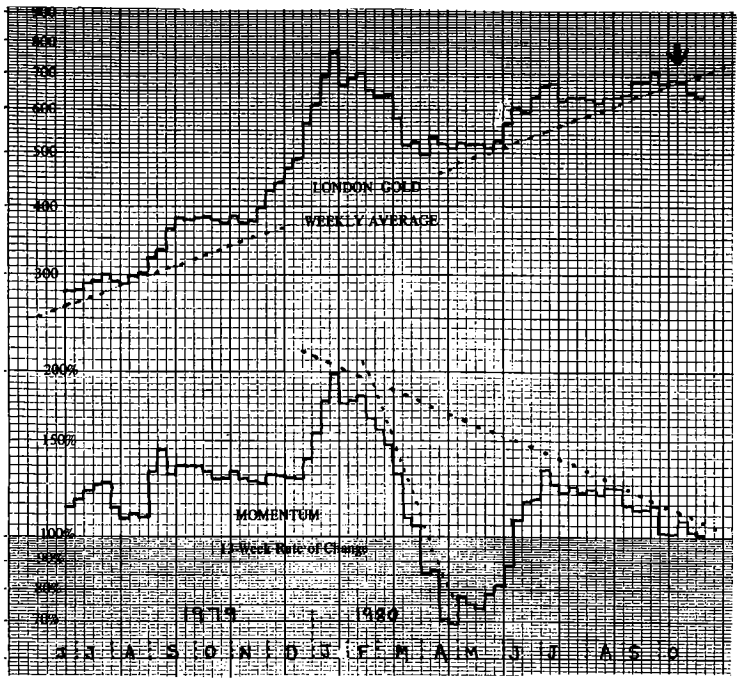
All right, let's turn to the action of bullion. The daily chart (1st and 2nd London fixes) shows the "head-and-shoulders" top I have been talking about in the last few Letters. The neckline (A on chart) was broken last week. and gold promptly sank below 630. As a rule in this kind of pattern the price action will take the item at least as far below the neckline as the distance from the top of the head to the neckline. Since the distance from the head (720) to the neckline is about 60 points (720 to 660), we might expect gold to drop 60 points or more below 660, and that would be about 600. The last area of key support came in at the August low of 605, so it is probable that any weakness would find excellent support ot 600.



Turning to my chart of gold momentum (13 week rate of change) note that momentum hit a high of 133 on the week of July 3, and after that despite the rising gold momentum trended down. That kind of action is never good, and the week of September 25 saw the high for gold. Since then it has been drifting with the head-and-shoulders pattern starting to form in September.

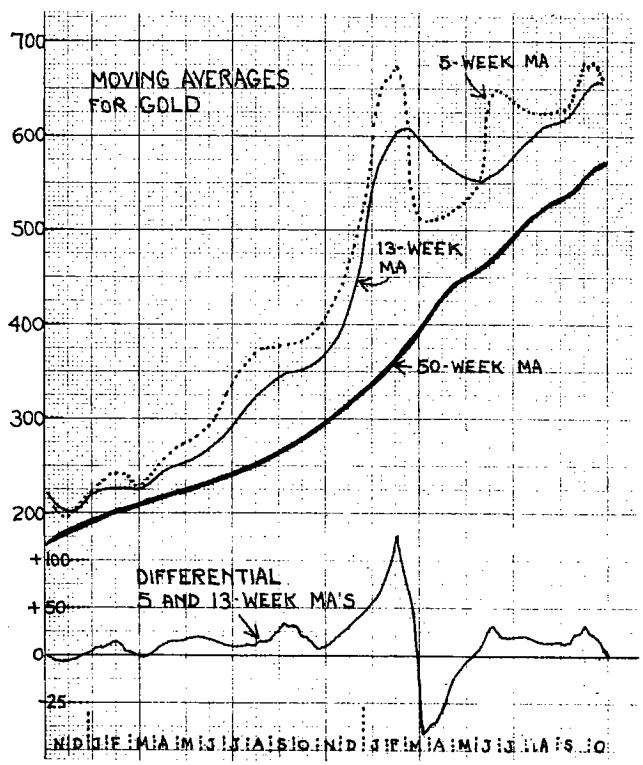
Gold momentum (chart, page 6) was 100.9 for last week, and if gold momentum is to stay above 100, the price of bullion will have to average better than 617 over the next few weeks. Many technical studies point to the importance of the 600 to 615 area as a crucial support zone.

Next, turn to the study of the three moving averages (MA's) of gold. As of the week ending October 30, the 5-week MA of gold was down to 653.17. This was just 0.10 below the 13-week MA which was 653.27. Finally, the long-term or 50-week MA was 574.84, an all-time high.



If the price of gold averages anything significantly below 650 this week, the 5-week MA will make a decisive penetration below the 13-week MA for the first time since June. In order to turn this study intermediate-term bullish, gold will have to move above the 655 area and hold there.

With everyone and his brother having predicted "900 to 1000 gold by the end of 1980" (Jim Sinclair excepted), what has happened? My own belief is that gold smells a whiff of deflation in the air. With interest rates marching up again, with business sluggish, with debt building and with the consumer hard pressed to pay his bills, there is at least some doubt about the thesis of



"inflation forever." Yes, I know that some people blame Russian gold-using jewelry business (and jewelry use is a huge factor in gold consumption), I personally believe that gold is reacting to the possibility of a credit squeeze in the period ahead. If we can get through 1980 without the interest rate structure and the rising debt playing havoc with the economy, I'll be amazed.

If the "big Squeeze" does come, there's going to be a huge premium on cash (that's what we pay our bills with). Such a squeeze would, in my opinion, knock everything down from the price of rare coins to the price of used cars.

FINAL THOUGHTS: Everytime the PTI looks as though it's going to plunge through that rising trendline–pop, up it goes. And that's what happened on Friday, October 31. Note on the page 3 chart that the PTI is now about halfway between its 1351 peak and the rising trendline. Most of my readers now follow the PTI closely, and as I've written so many times, this indicator cannot be predicted. The fact is that it surprises me over and over again. Just looking at the market action of the last few weeks, I would have sworn that the PTI would have smashed below its rising trendline. It didn't, and it has really put on an incredible performance.

A subscriber asked me to dream up the scenario that would most shock the market. "Yeah," I answered, "here's one for you. Carter is re-elected, and the market takes off on the upside."

* *

I'll be in New Orleans by the time you receive this report. My favorite spot in New Orleans–Jackson Square where the artists will paint your picture for $5 and Ol' Miss flows by just a hundred yards away. I think it reminds me of Washington Square where I went to college way back in those innocent 1940's.

MUSINGS: Happily, I have some space at the end of this report, and I still have things to say. I note that last week the yield on the D-J Municipal Bond Average jumped almost half a percent to a record 10.43%. This is a tax free yield, worth near 30% if you're in the highest tax bracket. At the same time, the D-J 20 Bond Average yields 12.72%, a fat 6.88% over the yield on the Dow. On page 7 of this week's *Barron's*, its Editor suggests that "The long term bond market may not survive." I passed our local bookstore and noted many books about "the coming currency collapse" and the "death of the dollar."

Meanwhile, the dollar is a very hot currency, having recently rallied strongly against the Swiss franc, the German mark, and Canadian dollar and what have you. "Wouldn't it be a shocker," I thought, "if the dollar (cash) became the hottest thing around and everything else collapsed." Of course that probably won't happen, but it occurs to me that the scarcest thing around is cash, and despite the fact that we've been told for years that "cash is dirt," they're paying us huge amounts today to rent it (that's called interest), so how bad can cash be?

The latest *Bank Credit Analyst* opines that interest rates are coming down in 1981. I don't know, but I do know that some of the closed-end bond funds are near record lows (they're traded on the NYSE) and yielding a fat 13%. Three that come to mind are Excelsior, Pacific American Income and Current Income. If you like contrary opinion, you might try a package of three. I would bet that sometime in the next year or so we will get a 10% to 20% bond rally. With the current 13% yield and a 10-20% rally, that's between a 23-33% profit. An interesting risk-reward situation.

NEXT MAILING: November 19th